Q2 2023

UBAM – DIVERSIFIED INCOME OPPORTUNITIES

Quarterly Comment

For Professional Investors in Switzerland or Professional Investors as defined by the relevant laws. The classification of the fund(s) as per the Sustainable Finance Disclosure Regulation (SFDR) is available on ubp.com or in the latest prospectus.

Market Comment

- After the spike in volatility during March, the quarter started on a much quieter stance as equities rebounded and credit spreads and rates stabilized over April. With the US President Joe Biden and Kevin McCarthy, Speaker of the United States House of Representatives, eventually reaching an agreement to raise the nation's borrowing limit a new episode of volatility over the US debt ceiling was avoided. Markets found support in the resilient US economy and less hawkish tone from the US Federal Reserve. The Fed raised its interest rate to 5.25% over the quarter, with only one rate hike of 25bp in May. Over the quarter we saw an upward shift in the US yield curve: 3-month treasury yield moved higher by 56bp while the US 10-year rate rose by 36bp to 3.48%. Most of the front-end increase was driven by real yields as the near-term breakeven inflation rate fell. This echoes the overall fall in inflation with the latest US CPI print at 4% in May 2023.
- In the meantime, the ECB increased its policy rates by 50bp and the BOE hiked twice for a total of 75bp. Their main focus is still inflation which hasn’t fallen enough. In Europe, the economic surprise index has been falling sharply. Deterioration in Europe is exhibited by the manufacturing PMI below 50, at 43.4 indicating contraction in activity, while services are holding better at 52. German yield curve inversion deepened over the quarter as the front end of the curve increase more than the long end. Indeed, the 3-month yield rose by 66bp while the 10-year yield increased only 10bp over the last 3 months.
- Overall volatility has fallen through Q2 across asset classes. High Yield credit spreads tightened during Q2 down by 53bp and 28bp in the US and Europe respectively. IG spreads also fell in the US and Europe over the second quarter by 15bp and 7bp respectively. Spreads across emerging market debt sectors have been compressing as well. Hard, Local and Corporate IG EMD spreads ended the quarter 52bp, 76bp and 38bp lower respectively.

Performance Review

- In Q2, the UBAM – Diversified Income Opportunities posted a +0.2% performance after fees (IC USD share class). This brings year-to-date performance to +1.8%.
- Quarter-to-date, the best contributing segment of the strategy was investments in Emerging Market Debt, and Local EMD in particular (+40bp). The core portfolio exposure to Investment Grade credit contributed 26bp while our tactical play on CoCos returned 14bp this quarter.
- With the rise in the US yield curve, our relative short duration exposure detracted 43bp from the fund’s performance this quarter.
- As the USD slightly increased over the quarter, our EM currency and JPY exposures had a negative impact on performance quarter to date, by 35bp.

All performance figures are given net of fees. Past performance is not a guide to current or future returns. See full disclaimer at the end of the document.

Portfolio Activity

- Our portfolio's yield stayed relatively stable over the quarter and stood at 6.2% at the end of June, 1.1% higher than the USD cash rate at 5.1%.
- In line with the overall tightening in credit spreads, the portfolio's average spread moved 44bp lower over the quarter to 160bp by the end of June.
- We slightly increased our exposure to non-USD currencies this quarter. The portfolio holds a 7.7% net short USD exposure as at the 30th June.
- During Q2, we slightly increased our portfolio duration from 2.7 to 3.3.
- The portfolio's average credit rating is BBB+ as of the end of June.

Outlook

- Even though we should be avoiding recession, global GDP growth is moderating, with Europe facing a challenging environment while the US economy appears more resilient. We expect inflation to continue to move lower over the next few months, however the pace of decrease is likely to slow as core inflation, driven by tight labour market and services, is more resilient. In this context we should see a normalization in interest rates, but we also believe the central banks' rate hiking cycle enters a new phase which should lead to less volatility. That being, uncertainty around the future decisions from central banks persists and the uneven market performances create confusion. Equity and bond markets are sending mixed messages and rather opposite views of the current state of the cycle. In one hand market implied rates are anticipating the first cut from the Fed as soon as Q1 2024, which is in line with significant slowdown in economic growth. In the other hand, equities are rising, and consensus expectations are showing a rebound in earnings growth by Q1 2024, this would be supported by stronger economic activity.
- We continue to see value in CoCos, with about 70% of outstanding issues still trading as perpetual, while European banks fundamentals are improving and exhibiting solid capital and asset ratio.
- As default rates are, slowly, increasing and PMI indices turned lower we continue to hold a preference for Investment Grade over High Yield, we believe IG will deliver a better risk-adjusted return over the medium term.
- We believe Emerging Markets central banks are closer to the end of their tightening cycle and inflation is expected fall quicker than in developed markets. This scenario would be as more favourable to carry in sovereign bonds and to the outperformance of local EMD. markets given that inflation was also slowing in emerging markets, but central banks holding off cutting rates DM central banks hadn't reached the end of their monetary cycle.

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